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Some Thoughts on the Incidence of Foreign Taxes

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SPECIAL REPORT

TAX ANALYSTS

SOME THOUGHTS ON THE INCIDENCE OF FOREIGN TAXES

By Deborah A. Geier

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In this article, she uses the *Compaq Computer* case to explore more generally the issue of whether foreign taxes should be made noncreditable (but rather only deductible) in those situations in which the economic burden or incidence of the tax is not borne by the U.S. taxpayer seeking to credit it. The situation in which this is most likely to occur is in connection with foreign gross withholding taxes, though the problem can arise in other contexts as well. The author would like to thank Cliff Fleming, Norm Stein, and Susan Hamill for their comments on an earlier draft. The usual disclaimer applies that they might not agree with all that is written here.

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While I am late to comment on it (I fell woefully behind in my reading), George Yin's Letter to the Editor of last November[1] makes an important point regarding the outcome, if not the explicit reasoning, of the *Compaq Computer*[2] case. His point is worth exploring in a little more detail in view of the centrality of the approach blessed in *Compaq Computer* to the recently issued proposed and temporary corporate tax shelter regulations that incorporate the economic-profit test enunciated in Notice 98-5.[3]

In challenging the conclusion of Messrs. Burgess and William Raby that the *Compaq Computer* court ignored the worldwide tax exposure of Compaq Computer in denying the corporation's foreign tax credit, Professor Yin wrote:

[1]George K. Yin, "Making Sense of the *Compaq Computer* Case," *Tax Notes*, Nov. 8, 1999, p. 815.

[2]113 T.C. No. 17, *Doc 1999-30659 (22 original pages)*, *1999 TNT 183-7* (September 21, 1999). Other commentary appearing in *Tax Notes* on the case includes Marc D. Teitelbaum, "*Compaq Computer* and *IES Industries* — The Empire Strikes Back," *Tax Notes*, Feb. 7, 2000, p. 829; John F. Prusiecki, "One More Analysis of the *Compaq* Decision," *Tax Notes*, Nov. 29, 1999, p. 1208; Marc D. Teitelbaum, "An Alternative Analysis of the *Compaq* Decision," *Tax Notes*, Nov. 8, 1999, p. 816; Burgess J.W. Raby & William L. Raby, "Economic Substance Needed for Foreign Tax Credit," *Tax Notes*, Oct. 11, 1999, p. 211; Lee A. Sheppard, "Courts Combat Cross-Border Corporate Tax Shelters," *Tax Notes*, Oct. 11, 1999, p. 137.

[3]On February 28, 2000, the Treasury Department issued proposed and temporary regulations pertaining to corporate tax shelters. In T.D. 8875, *2000 TNT 40-15*, the Treasury issued regulations describing those transactions for which a promoter must maintain a list of investors. In T.D. 8876, *2000 TNT 40-16*, the Treasury issued regulations describing those transactions that a promoter must register with the IRS. In T.D. 8877, *2000 TNT 40-17*, the Treasury issued regulations describing those transactions that a corporate participant may need to disclose. On the same day, the IRS issued Notice 2000-15, 2000-12 IRB 826, *Doc 2000-5712 (3 original pages)*, *2000 TNT 40-14*, which contains a list of identified transactions triggering the registration, disclosure, and customer list requirements elaborated in the regulations, and one item on that list is any transaction described in Notice 98-5, 1998-3 IRB 49, *Doc 98-175 (16 pages)*, *97 TNT 247-3*, in which the reasonably expected economic profit is insubstantial in comparison to the value of the expected foreign tax credit.

I don't think it's accurate to describe the court as having overlooked the worldwide tax consequences of the transaction to the taxpayer. Rather, a better explanation is that the court took such consequences into account, but simply concluded that the [foreign gross withholding tax that Compaq Computer sought to credit] had not "really been paid" by the taxpayer. Although the taxpayer nominally paid the Netherlands tax (actually, because it was a withholding tax, the taxpayer did not even do this), the real incidence of the tax fell elsewhere.[4]

I think that one way to read his letter is that the economic-profit test adopted in both *Compaq Computer* and Notice 98-5 should best be understood as merely a proxy, in the most visibly abusive situations, for the real underlying inquiry: whether the U.S. taxpayer seeking to credit the foreign tax under review actually bore the economic incidence of that tax. As explored below, a foreign tax credit is warranted, in theory, only if the U.S. taxpayer bore the economic incidence of the foreign tax.

The economic-profit test will likely be flunked in any case in which the taxpayer is successful in shifting the incidence of the foreign tax to another. But the economic-profit test fails to prevent the crediting of many foreign taxes that are economically borne by factors in the marketplace other than the U.S. taxpayer on whom they are nominally imposed. That is, it does not go *far enough* when one understands the underlying economics that taxpayers like Compaq Computer wish to exploit. When one understands the underlying incidence inquiry, one should question whether Treasury regulation section 1.901-2(f)(2)(i) should be withdrawn, as well as an old ruling (I know that it's old because it was issued the year I was born), Revenue Ruling 57-106. Going even farther, I think it fair to question the legitimacy of crediting (as opposed to merely deducting) *all* foreign gross withholding taxes on investment income, such as dividends, interest, and royalties. The economic-profit test of *Compaq Computer* and Notice 98-5 (as well as the holding-period test of section 901(k) discussed in Part II) would not be necessary if foreign gross withholding taxes were made noncreditable (but only deductible) as a class.[5]

In today's modern marketplace, there are serious questions (deserving of additional empirical study) regarding whether foreign gross withholding taxes on foreign-source investment income are economically borne by the nominal U.S. payor. If the nominal payor does not typically bear the economic burden of foreign gross withholding taxes, they ought not to be creditable, regardless of how "innocent" or "manipulative" the particular taxpayer and purchase transaction appear to be; even stocks and bonds purchased for good business purposes and held for a substantial period of time are likely priced in such a fashion that the nominal payor of the gross withholding taxes that are creditable under current law does not bear the economic burden of those taxes. If that is true, than no foreign tax credit is warranted; only a deduction should be granted (to offset the "gross up" that occurs in the case of all foreign gross withholding taxes, whether or not the withholding tax is creditable).

Part I briefly reviews, one more time, the facts of *Compaq Computer* for purposes of illustrating the ensuing discussion. Part II briefly describes Congress's response to transactions like that in *Compaq Computer* in section 901(k). Part III quotes Elizabeth Owens's seminal work on the foreign tax credit as it pertains to the incidence question. Part IV returns to *Compaq Computer* and related scenarios and argues that Treasury regulation section 1.901-2(f)(2)(i) and Revenue Ruling 57-106 should be withdrawn and that the creditability of foreign gross withholding taxes in general ought to be revisited from within the context of today's marketplace.

I. The *Compaq Computer* Facts (Again)

In July 1992, Compaq Computer realized a substantial capital gain on the sale of shares in another computer company that it owned. On September 16, 1992, Compaq Computer purchased 10 million ADR shares of Royal Dutch Petroleum for a total purchase price of $887,577,129, cum net dividend. That is, the purchase price reflected a declared gross dividend of $22,545,800, *less* Netherlands withholding tax of $3,381,870, that would be paid to Compaq Computer as holder of record on the dividend date. The decision makes clear that the "fair market value" purchase price that Compaq was willing to pay for the ADR shares on the open market was calculated by adding only the *net* $19,163,920 dividend to the ex-dividend share price, not the gross dividend.[6] These purchase transactions were executed with "next day" settlement terms.

On the same day, Compaq sold the ADR shares, ex dividend, with "five day" settlement terms. The aggregate selling price was $868,412,129, producing a net loss (ignoring selling expenses, which are reflected below) of $19,165,000.

On October 2, 1992, Royal Dutch Petroleum paid to Compaq the net dividend of $19,163,930 to which it was entitled as holder of record on the dividend date of the 10 million ADR shares. As it was required to do, Compaq included in gross income the full $22,545,800

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[4]Yin, *supra* note 1. Professor Yin cited in a footnote several of the authorities discussed in this article.

[5]Notice 98-5 actually considers two disparate scenarios. The first is "the acquisition of an asset that generates an income stream subject to foreign withholding tax." The second is "effective duplication of tax benefits through the use of certain structures designed to exploit inconsistencies between U.S. and foreign tax laws." I think that these are two distinct problems, with only the first revolving around the incidence of the foreign tax. The second problem is not addressed in this article.

[6]The investment advisor advising Compaq Computer "selected the market prices to be paid, varying the prices in different trades so the blended price per share equaled the actual market price plus the net dividend." *Compaq Computer*, 113 T.C. No. 17.

gross dividend, even though it received only $19,163,930. A deduction of the foreign withholding tax would have merely reduced Compaq's taxable income to the net dividend actually received. But Compaq sought instead to credit the $3,381,869 foreign withholding tax, which, of course, has far more favorable tax consequences, with each $1 of foreign tax reducing U.S. tax by $1.

Considering only the sale loss and the net dividend, Compaq realized a negative cash flow of $1,070 from the transaction ($19,165,000 loss less $19,163,939 net dividend). After taking into account commissions, SEC fees, etc., the Tax Court concluded that Compaq incurred a net economic loss (before taxes) of $1,486,755.[7]

The government challenged the availability of the foreign tax credit. Holding in favor of the government, the Tax Court made the following three findings of fact:

> Every aspect of petitioner's ADR transaction was deliberately predetermined and designed by petitioner . . . to yield a specific result and to eliminate all economic risks and influences from outside market forces on the purchases and sales in the ADR transaction.
>
> Petitioner had no reasonable possibility of a profit from the ADR transaction without the anticipated federal income tax consequences.
>
> Petitioner had no business purpose for the purchase and sale of Royal Dutch ADR's apart from obtaining a federal income tax benefit in the form of a foreign tax credit while offsetting the previously recognized capital gain.[8]

II. Section 901(k)

While it had no application to the year at issue, section 901(k), enacted in 1997, explicitly addresses a transaction of this type arising today. Instead of adopting an economic-profit test, it adopts a different proxy test. In general, it disallows the crediting of a foreign tax withheld on a dividend if the taxpayer did not hold the stock for more than 15 days during the 30-day period beginning 15 days before the stock goes ex-dividend or if the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property (such as in a short sale). The holding period is increased to more than 45 days during the 90-day period beginning 90 days before the stock goes ex-dividend in the case of preferred stock. As under section 246(c), the holding period is reduced for any period during which the taxpayer's risk of loss is diminished.

A credit that is disallowed under section 901(k) can nevertheless be deducted.[9] This allowance might seem at first blush to represent untoward generosity. After all, if the foreign tax is not considered economically borne by the dividend recipient (as argued below) — which is why a foreign tax credit is disallowed in the first place — why should the dividend recipient be permitted even to deduct the foreign tax? The answer lies in the fact that the gross dividend, not merely the net dividend, must be included for U.S. tax purposes in all cases under current law — whether or not a foreign tax credit is allowed. Since Compaq Computer must include the full $22,545,800 gross dividend in its U.S. gross income under current law, the deduction of the $3,381,870 foreign gross withholding tax accurately reduces the net inclusion to the $19,163,930 that it actually received. Since Compaq actually received only $19,163,930, it should be taxed on no *more* than that amount. (If a foreign tax credit is allowed instead, Compaq effectively is taxed on much less than that amount.)

Another way that the statute could reach the same result in those cases in which the tax withheld is not creditable (because not considered economically borne by the dividend recipient) would be to require taxpayers to ignore the withholding tax altogether, as though it were not imposed on the dividend recipient at all. Under this approach, only the net dividend actually received would be includable in gross income in the first place. Perhaps this view is the more accurate way to perceive what is actually going on in these situations. The current statute simply takes a roundabout way of mechanically getting there — by requiring inclusion in gross income of the "phantom income" (equal to the withholding tax) in *all* cases and then allowing an immediate deduction of that same amount if the dividend recipient is not deemed to have borne the economic burden of the foreign gross withholding tax. If the taxpayer *is* considered to have borne the economic burden of the tax, then there is no deduction but the taxpayer is eligible to credit the foreign tax against the U.S. tax due.

It might, therefore, be less confusing to think about it in the following way: If a foreign tax credit is allowed because the dividend recipient is deemed to have borne the economic incidence of the tax, the net dividend inclusion must be "grossed up" to reflect the withholding tax paid. (It would be improper not to gross the net dividend up by the amount of the withholding tax if the dividend recipient is deemed to have actually borne the economic burden of the tax and thus is allowed to credit it for U.S. tax purposes.) If a foreign tax credit is *not* allowed because the dividend recipient is *not* considered to have borne the economic burden of the foreign gross withholding tax in the first place, the dividend recipient must ignore the withholding tax altogether, including only the net dividend actually received.[10]

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[7] *Id.*

[8] *Id.*

[9] *See* section 901(k)(7).

[10] *See* Prusiecki, *supra* note 2 (concluding that "Compaq received a U.S.-taxable, withholding-tax-free dividend of $19,163,930, rather than a U.S. taxable, withholding-taxable, foreign-tax-creditable (for withholding) dividend of $22,545,800" and that "Compaq paid no foreign tax and gets no foreign tax credit").

Several other code sections that disallow or reduce a foreign tax credit nevertheless allow a deduction of the tax, though they have distinctly different rationales that have

(Footnote 10 continued on next page.)

The material in Parts III and IV question whether the focus on holding period in section 901(k) really cures the underlying problem. I doubt that it does.

III. The Crucial Importance of Incidence

In her classic 1961 treatise on the foreign tax credit, Elizabeth Owens argued that the incidence of the foreign tax was crucial to the definition of which foreign taxes ought to be creditable for U.S. tax purposes. Two paragraphs are worth quoting in full.

> On analysis, it appears that the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax. Double taxation of a taxpayer's income occurs only if that taxpayer has borne the burden of both the United States income tax and the foreign tax for which a credit is claimed. Strictly speaking, therefore, a foreign tax should be credited only if the taxpayer could demonstrate the incidence of the foreign tax and of the United States tax against which the credit would be taken, and could prove that his potential income was in fact reduced by both taxes. The tax credit system is, in other words, based on assumptions about the economic incidence of creditable taxes. It would, however, be very difficult, if not absolutely unfeasible, from an administrative standpoint to demonstrate conclusively in litigation the incidence of a particular tax paid by a particular taxpayer for a particular tax year or years. In other words, it is not practicable to decide individual cases in the light of the policy of the foreign tax credit provisions. It seems probable that the relevance of tax incidence is often recognized both by the litigants and the courts but either because of the inherent difficulties of proof, or because all parties make the same assumptions, whether justified or not, about the incidence of particular taxes, this consideration is not explicitly discussed in the rulings or court decisions. While reliance on technical distinctions in interpreting the statutory provisions can thus be justified, this does not mean that it is either necessary or proper to disregard the question of tax incidence in drafting the statutory tax credit provisions which grant a credit for certain broad categories of foreign taxes.
>
> The relationship of the economic incidence of foreign taxes to the issue of qualification arises out of the reasons for which a tax credit is granted. The first reason is the desire to provide equitable tax treatment as among United States corporations, citizens, and residents regardless whether their income is derived from United States sources or is derived from foreign sources and is subjected to foreign taxation. The United States income tax system is based on the principle that taxpayers with an equal amount of income should bear an equal tax burden. Adoption of the credit system involves an attempt to extend this principle by taking into account the burden of foreign taxes. If, however, a foreign tax is shifted or passed on by the person upon whom it is imposed, there is no reason to grant a credit since the foreign tax does not add a tax burden in addition to that of the United States income tax. The second reason for the credit is the desire to establish tax neutrality as between foreign and domestic trade and investment. The economic function of the foreign tax credit is to remove a disincentive to the free flow of international trade and investment from the United States. The objective is to allow the investor to choose between foreign and domestic business operations free from tax considerations. Since this choice depends upon rates of return after taxes, a credit should be given only for taxes which are not passed on because it is only those taxes which affect profits after taxes. For both reasons, therefore, the economic incidence of a foreign tax should be a crucial element in deciding which categories of foreign taxes may be credited against the United States income tax.[11]

In other words, international tax norms are not offended if a foreign tax credit is denied for a foreign tax

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nothing to do with suspicions about the incidence of the foreign tax. For example, section 901(j) disallows the crediting of foreign taxes paid to countries with which the U.S. has severed diplomatic relations and countries identified by the Secretary of State as supporting acts of international terrorism, including Cuba, Iran, Iraq, Libya, North Korea, Sudan, and Syria. Yet, section 901(j)(3) nevertheless allows the deduction of those noncreditable taxes. *See also* section 908(a) (reducing the foreign tax credit, but allowing deduction of the tax, if the person "participates in or cooperates with an international boycott during the taxable year"). As Joseph Isenbergh notes, "[f]oreign taxes for which credit is disallowed under section 901(j) can still be deducted, however, which means that some tax benefit, although smaller, remains available for income taxes paid to the disapproved countries." Joseph Isenbergh, *International Taxation* para. 28.3.2 (1999) [hereinafter *International Taxation*]. Because the underlying rationale of the credit disallowance in these cases is not that the ostensible payor did not bear the economic incidence of the tax, but rather because the U.S. seeks to deter trade with such countries by U.S. business, perhaps the thinking is that disallowing the credit is enough of a disincentive so that going farther and disallowing a deduction is not necessary and would mis-measure the taxpayer's "income." *But see* section 280E (disallowing business expense deductions of drug dealers, even though such denial mis-measures their income, in order to deter the behavior). President Clinton's budget request for fiscal year 2001 proposes to amend the code to disallow foreign tax credits for taxes paid to blacklisted tax haven countries. The proposal does not make it clear whether or not the noncreditable taxes would be allowed as deductions. *See* Robert Goulder, "Clinton Proposes Tax Haven Blacklist," *Tax Notes*, Feb. 14, 2000, p. 896; Treasury Department, General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals (Feb. 7, 2000), *Doc 2000-3672 (234 original pages), 2000 TNT 27-27.*

[11] Elizabeth A. Owens, *The Foreign Tax Credit* 83-84 (1961).

that is shifted to another because the foreign tax credit seeks only to prevent two countries from imposing tax on the same income. If the foreign tax is not economically borne by the U.S. taxpayer who seeks to credit the tax, no reduction in U.S. tax is needed to prevent the double taxation. The foreign tax should be ignored (which is effectively accomplished if only a deduction is allowed to offset the gross up for the "phantom income" equal to the tax itself). Moreover, economic neutrality does not demand that such taxes be creditable. Indeed, allowing full advantage of the foreign tax credit for foreign taxes that have been shifted to another violates economic neutrality by encouraging inefficient transactions that have no purpose other than to reduce U.S. tax.

IV. *Compaq Computer* Reprise

A. Foreign Taxes on Publicly Traded Stock

In enacting section 901(k), Congress demonstrated a concern that taxpayers like Compaq Computer were able to purchase foreign stock from sellers who were unable to use the foreign tax credits that accompany the dividend stream on such stocks. The legislative history states:

> [S]ome U.S. persons have engaged in tax-motivated transactions designed to transfer foreign tax credits from persons that are unable to benefit from such credits (such as a tax-exempt entity or a taxpayer whose use of foreign tax credits is prevented by the limitation) to persons that can use such credits. These transactions sometimes involve a short-term transfer of ownership of dividend-paying shares. Other transactions involve the use of derivatives to allow a person that cannot benefit from the foreign tax credits with respect to a dividend to retain the economic benefit of the dividend while another person receives the foreign tax credit benefits.[12]

Why is this a concern?

The fair market value of an asset is generally recognized as being the present value of the future stream of payments to be received with respect to the asset.[13] As discussed more fully below, if the seller, the buyer, and market participants in general are all able to take advantage of the U.S. foreign tax credit on the dividend stream paid on the foreign stock, then the "fair market value" purchase price of the stock should reflect the net present value of all future *gross* returns on the stock, without reduction for any withholding taxes. That is, buyers should be willing to pay (and sellers should be in a position to demand) a price that reflects the future withholding taxes because those taxes will be able to be credited, dollar for dollar, against the U.S. tax due on the income stream. In such a case, the buyer suffers the economic burden of those foreign gross withholding taxes in the purchase price of the stock.

But if the seller is unable to take advantage of the U.S. foreign tax credit, he might not be in a position to demand a price that reflects the foreign tax. In that case, the *seller* of the stock may be the party that bears the economic burden of the foreign withholding tax in the form of a reduced selling price for the stock that does not reflect the future *gross* return on the stock but rather only the future *net* return on the stock, as reduced by the withholding taxes. In such a case, the buyer of the stock who seeks to credit the foreign gross withholding taxes never incurred the economic burden of those withholding taxes in the form of a purchase price for the stock that reflects them. Rather, the purchase price reflects only the net return, exclusive of the foreign tax.

In *Compaq Computer*, the stock purchases and sales were conducted over the New York Stock Exchange, and thus we cannot know whether the "sellers" of the ADR shares to Compaq Computer were exempt from U.S. taxation or in an excess foreign tax credit position. It seems to me, however, that the problem arises not only where the seller is actually a tax-exempt organization or in an excess foreign tax credit situation. Whether or not the particular seller is so exempt, the market price in Dutch Petroleum shares over an organized exchange will not likely reflect the higher price that only buyers able to take advantage of the U.S. foreign tax credit should be willing to pay for such shares. There are not likely enough such buyers to bid up the price of these shares to fully reflect the gross dividend, without reduction for the withholding tax. This is likely true not only because U.S. taxpayers may be in excess foreign tax credit positions but also — more importantly — because U.S. pension funds, which are tax-exempt, own a non-trivial amount of foreign stocks.[14] Thus, the market price most likely

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[12] S. Rep. No. 105-33, at 175-76 (1997). *See, e.g., IES Industries, Inc. v. United States*, No. C97-206, *Doc 1999-32487 (5 original pages), 1999 TNT 196-60* (N.D. Iowa, Sept. 22, 1999) (describing a *Compaq Computer*-type transaction where it was clear that the seller of the "pregnant" dividend stock was a tax-exempt pension fund).

[13] *See* Joseph M. Dodge, J. Clifton Fleming, Jr., and Deborah A. Geier, *Federal Income Tax: Doctrine, Structure, and Policy* 471 (2d ed. 1999).

[14] Significant investment in foreign equities by U.S. pension funds is a relatively recent phenomenon, which provides an additional reason to revisit now the issue of whether gross withholding taxes on such income should be creditable in the modern investing environment. "In 1983, only 0.7 percent of the holdings in private pension funds were international; by 1993 that percentage had risen to 5.7 percent or $203.6 billion in assets." Rick A. Haberman, Note, "It's Not Your Father's Pension Fund: ERISA's Prudent Investor in the International Market," 22 *J. Corp. L.* 771, 773 (1997) (footnotes omitted). The 1999 numbers show a dramatic increase over these 1993 numbers.

> Leading U.S. pension funds poured big bucks into overseas stock markets last year, with a record number holding at least $1 billion in actively managed, international equity portfolios. As of September 30, 66 of the top 200 pension funds reported $1 billion or more in actively managed international equity portfolios in their defined benefit plans, an increase of more than 40 percent from a year earlier. The active, international

(Footnote 14 continued on next page.)

reaches equilibrium at a level that reflects only the *net* future return (exclusive of the foreign withholding taxes), not the *gross* future return (inclusive of the foreign taxes). In other words, the buyer is able to acquire the dividend stream at a price that does *not* reflect the withholding taxes, i.e., at a price that shows that the seller, not the buyer, was the party that suffered the economic burden of the foreign taxes.

The facts in *Compaq Computer* serve as compelling anecdotal evidence of this phenomenon. Recall that Compaq Computer was able to purchase the shares on the open market, cum dividend, at a "fair market value" that reflected the ex-dividend price plus an amount almost exactly equal to the upcoming *net* dividend, sans withholding tax, of approximately $19.1 million. In other words, Compaq Computer did not bear the economic incidence of the $3.3 million withholding tax, as it would have if it had paid an amount for the shares that reflected the full gross dividend of $22.5 million about to be distributed. Though the tax may be legally imposed on Compaq Computer under the foreign tax statute, and the withholding agent appears to be paying the tax on behalf of Compaq Computer, Compaq Computer did not bear the economic burden of that tax.

While the facts in *Compaq Computer* illustrate the phenomenon most clearly because a dividend was impending, and thus cum-dividend prices and ex-dividend prices could be easily compared, I suspect that the same pricing mechanism is at work on a day-to-day basis for most such property. That is, it is likely true that there are not enough U.S. purchasers able to take advantage of the foreign tax credit with respect to the income paid on publicly traded foreign stock for the U.S. market price to reach equilibrium at a level that accounts for the availability of the tax credit. As discussed below in subpart C, this is also likely true with respect to privately purchased property. At the least, empirical work should establish whether or not this pricing phenomenon is more often true than not for assets producing income subject to foreign gross withholding taxes.

And note that this pricing mechanism, if true, is true no matter how long stock, if that is the asset at issue, is held. That is, section 901(k)'s restrictions on the crediting of foreign gross withholding taxes on dividends can be avoided by holding the stock for the requisite number of days, even though the price paid by the Compaq Computers of today likely reflects only the present value of all future *net* returns on the stock in any event.

In short, buyers like Compaq Computer are able to pay a "fair market value" for foreign stock that does not reflect the portion of the future dividend stream that will be withheld by the payer; it pays a "fair market value" that reflects only the *net* dividend stream, as reduced by the withholding taxes, that it will actually receive. If Compaq Computer were permitted nevertheless to credit the foreign gross withholding tax, at the price of only a gross-up of the net dividends actually received to the gross dividend deemed received, it would get a windfall, because the required gross up imposes less of a tax burden than the foreign tax credit (equal to the gross up) produces in tax savings. With respect to the dividend that Compaq Computer received, for example, the $3.3 million gross up (in rounded numbers), at the highest section 11 marginal rate of 35 percent, results in an additional tax of approximately $1.05 million, while the accompanying credit of $3.3 million results in a dollar-for-dollar tax reduction of $3.3 million. The imposition of the withholding tax actually creates a net profit for Compaq equal to $2.25 million, even though the machinations of the marketplace meant that the actual economic burden of that tax was not borne by Compaq Computer but rather (most likely) by the seller of the stock. And this would likely be true regardless of how long Compaq Computer owned the stock and regardless of how benign the motive for the foreign stock purchase.

For this reason, it could be argued that the section 903 credit for a tax imposed "in lieu of" a generally applicable net income tax should be repealed with respect to an "in lieu of tax" that takes the form of a gross withholding tax, and that other gross withholding taxes that are not imposed in lieu of net income taxes should be made noncreditable as well, regardless of whether or not the tax is "almost certain to reach some net gain."[15] As Elizabeth Owens wrote: "[T]he

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equity portfolios of the 200 largest employees benefit funds rose to a shade less than $252 billion, a market-adjusted increase of 13 percent from a year earlier. . . . International bond holdings also fared well in the face of weak global bond markets . . . . The top 200 corporate defined benefit funds had an average 15.4 percent allocation to international equity in 1999, the same as a year earlier. The top 200 public funds, however, saw the average asset in overseas stock rise to 13.9 percent last year from 11.2 percent a year earlier.

Bruce Kelly, "Active Foreign Equities Up Market-Adjusted 13 Percent," *Pension & Investments* (Jan. 24, 2000). For example, the three largest pension funds last year were: the California Public Employees defined benefit plan (total assets of $155,711 million), with 19.5 percent in foreign stocks and 3.8 percent in foreign fixed income assets; the New York State Common defined benefit plan (total assets of $111,369 million), with 11.8 percent in foreign stocks; and the California State Teachers defined benefit plan (total assets of $98,400 million), with 25.1 percent in foreign stocks. *See id.* at 47, 72, and 48. And not only the largest funds invested significantly in foreign equities. The bottom 800 (in size) of the top 1,000 defined benefit corporate funds had an average asset mix of 14.9 percent foreign equity and 1.5 percent foreign fixed-income assets, and the bottom 800 (in size) of the top 1,000 defined benefit public funds had an average asset mix of 13.8 percent foreign equity and 1.9 percent fixed-income assets. *See id.* at 42.

[15]Treas. reg. section 1.901-2(b)(4)(i). Gross withholding taxes imposed in lieu of an otherwise applicable tax imposed on net income are generally creditable under sections 903 and 901. A tax imposed on gross income that is not imposed in lieu of an otherwise applicable tax on net income must independently satisfy the tests intended to differentiate "income" taxes under section 901 from other taxes, including the requirement that the tax, even though imposed on a gross basis,

(Footnote 15 continued on next page.)

concept that gross income taxes should qualify [for the foreign tax credit] because the United States could constitutionally impose such taxes as income taxes is not only irrelevant in this connection but runs directly counter to the basic objective of crediting only nonshiftable taxes."[16]

B. The Section 901(i) Precedent

Denying a foreign tax credit (and allowing, in final effect, only a deduction instead) to a taxpayer who is deemed not to have borne the economic incidence of the tax — without regard to any "economic-profit" analysis — has a precedent. It has always been clear that a foreign tax that is actually refunded to a U.S. taxpayer is not creditable. This idea was expanded in Revenue Ruling 78-258[17] to include "refunds" of the tax to the person with whom the U.S. taxpayer did business. In that ruling, Brazil imposed a 25 percent withholding tax on interest paid by Brazilian borrowers to foreign lenders. In an effort to encourage the use of foreign funds by Brazilian borrowers, Brazil passed a decree under which 85 percent of the withholding tax was effectively rebated to the Brazilian borrower. X Corp was a U.S. bank that had outstanding loans to Brazilian borrowers.

For example, assume that U.S. X Corp is entitled to receive a gross $100 interest payment from a Brazilian borrower under the terms of a loan agreement. The Brazilian borrower withholds $25 from the payment, remitting it to the Brazilian government, which in turn returns $21.25 (85 percent of the amount withheld) to the borrower.

The ruling concluded, on our assumed facts, that X Corp could not take a foreign tax credit for the $21.25 portion of the withholding tax that was refunded to the Brazilian borrower and that X Corp, therefore, need not gross up the $75 net interest payment it received to reflect it. X Corp would include only $78.75 in gross income (the $75 net interest payment that it actually received plus the $3.75 withholding tax that was not refunded to the Brazilian borrower) and would take a foreign tax credit equal to $3.75.

The assumption underlying Revenue Ruling 78-258 is that, after the Brazilian subsidy program was instituted, the U.S. lender could escape the economic incidence of the foreign tax to the full extent of the foreign subsidy by raising the interest rate it charges to Brazilian borrowers to fully capture the subsidy, though that assumption is not likely true in all cases. As Joseph Isenbergh has phrased it: "Abstractly, the question whether the taxpayer bore the economic cost of the tax depends on who derived the benefit of the subsidy. That in turn depends on conditions of bargaining and overall supply and demand. Depending on how these play out, the economic benefit of the indirect refund of the tax may be returned to the [U.S.] taxpayer in the form of advantageous terms in the underlying transaction or largely retained by the subsidized third person."[18]

Revenue Ruling 78-258 was transmogrified into Treasury Regulations and eventually codified in 1986 in section 901(i). Section 901(i) creates a bright-line rule, denying the creditability of the portion of the withholding tax that is returned as a subsidy to the foreign borrower, without any showing that the U.S. lender did, in fact, capture the benefit of the subsidy by increasing its interest rates. The lender is simply presumed to have shifted the economic burden of the withholding tax to the borrower (to the extent of the subsidy). As described above in Subpart A (and unlike in the section 901(i) scenario), there is actually much less uncertainty regarding whether taxpayers like Compaq Computer bear the economic burden of foreign gross withholding taxes.

C. Foreign Taxes on Non-Publicly Traded Property

Even in cases of non-publicly traded property producing income subject to a foreign gross withholding tax, such as a copyright producing a royalty, there are likely not sufficient bidders who can take advantage of the foreign tax credit to bid up the purchase price of the copyright to a tax-inclusive level. For instance, Example 1 of Notice 98-5 recounts the story of a domestic corporation that purchased all rights to a copyright with only one royalty payment remaining, soon to be paid. The gross royalty due was $100, and the applicable foreign gross withholding tax was $30. In a perfect market, the buyer of this royalty should have been willing to pay $100, but the U.S. buyer was able to purchase the copyright for only $75. There must have been sufficient buyers able to use the foreign tax credit that the seller was able to capture $5 of the benefit of this tax attribute. In a market where few could take advantage of the U.S. foreign tax credit on the royalty, the market price likely would have been only $70.

Even in this situation, where the price paid is slightly above the tax-exclusive price, it would be defensible to cast this transaction in the no-credit camp, allowing only a deduction for the $30 tax (resulting in a net inclusion of only the $70 net royalty actually received). Just as in the case of section 901(i), where we can't be sure that the U.S. lender actually captures the entire benefit of the subsidy, we need sufficiently bright-line rules, and since it is much more likely than not that the buyers of such assets will pay much closer to $70 than they will to $100, it could be argued that the crediting of such foreign taxes is wrong in all cases, i.e., that only the net dividend, interest, royalty, etc., payments

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is almost certain to reach some net gain. For example, in *Bank of America National Trust & Savings Ass'n v. United States*, 459 F.2d 513 (1972), Bank of America was subject to a foreign net income tax that was concededly creditable as well as a second tax imposed on the gross income of banking businesses. The second tax was not creditable because it was not certain that a tax imposed on the gross income of a banking business would likely reach net gain in most circumstances; banks can operate at a loss.

[16] Owens, *supra* note 11, at 86.

[17] 1978-1 C.B. 239.

[18] *International Taxation*, *supra* note 10, at para. 29.12. *See also* Joseph Isenbergh, "The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes," 39 *Tax L. Rev.* 227, 244-47 (1984).

should be includable in all cases, and that no foreign tax credit for the gross withholding tax should ever be allowed.

Another area where this economic picture is common is private debt. For example, *Nissho Iwai American Corp. v. Commissioner*[19] involved the Brazilian subsidy program described in Rev. Rul. 78-258. The Tax Court upheld the validity of the regulations that preceded the enactment of section 901(i) and thus disallowed a foreign tax credit for the portion of the Brazilian withholding tax that was refunded to the Brazilian borrower in the case. An alternative argument made by the IRS, however, was that the *entire* tax — not merely the portion refunded to the Brazilian borrower — was made noncreditable because the loan arrangement between the borrower and U.S. lender entitled the lender to receive interest payments without reduction for any withholding taxes that might apply. For U.S. tax purposes, the U.S. lender grossed up the payment for the withholding tax paid by the borrower and then sought to credit the entire amount. The IRS argued that the loan terms meant that no tax was paid by the U.S. lender. The Tax Court disagreed, concluding that the legal liability for the tax was imposed on the lender and that the Brazilian borrower was "simply the person required to pay the tax on behalf of the foreign lender."[20]

This approach is currently blessed in Treas. reg. section 1.901-2(f)(2)(i), which provides that "[t]ax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as part of the transaction, to assume the taxpayer's foreign tax liability." I believe, however, that this regulation's approach of focusing on the *legal* incidence of the tax (as opposed to its economic incidence) provides an unjustifiable tax benefit for a tax that should be only deducted (to reduce the gross interest payment deemed received to the net amount actually received) rather than credited, because the economic burden of the tax was expressly shifted to the borrower.

In a similar case,[21] the Tax Court noted that these "net interest" contracts were (and, I presume, remain) quite common.

> In making loans to borrowers in Brazil and other countries, it was an accepted and common practice among foreign lenders to require that interest payments be made to them on a "net quoted" basis. A net loan is a loan in which the lender and the borrower have agreed that all specified payments of principal and interest to the lender, under the loan contract, will be made net of any applicable Brazilian taxes.
>
> Under Brazilian law, when the Brazilian borrower under a net loan assumes the burden of the withholding tax, the amount of interest remitted is considered net of tax and an adjustment known as a "gross-up" is required to be made for purposes of computing the withholding tax. This gross-up adjustment would be computed as follows:
>
> $$\textit{Grossed-up interest} = \frac{\textit{Net interest}}{1 - \textit{withholding tax rate}}$$
>
> . . .
>
> From 1970 through 1986 [the last year at issue], net loans generally were the predominant type of loan extended by foreign lenders to borrowers in Brazil. With a net loan, the foreign lender shifts the risk of any increase in taxes imposed by the borrower's country to the borrower. Correspondingly, in a net loan, the borrower, not the foreign lender, will benefit from any reduction in or waiver of taxes imposed by the borrower's country.[22]

D. Additional Evidence and a Nice Side Benefit

Making foreign gross withholding taxes noncreditable (but rather only deductible) as a class may not only be defensible in theory but also might reduce the complexity of the basket system implemented under section 904(d).[23] Indeed, Congress felt the need

[19] 89 T.C. 765 (1987).

[20] Id. at 773.

[21] *Riggs Nat'l Corp. v. Commissioner*, 107 T.C. 301, *Doc 96-31895 (92 pages), 96 TNT 240-2* (1996).

[22] *Id.* at 306-07.

[23] Simplifying the foreign tax credit was one of the top simplification recommendations recently made by a joint submission to Congress drafted by the American Bar Association Section of Taxation, the American Institute of Certified Public Accountants, and the Tax Executives Institute. *See* Ryan J. Donmoyer, "Tax Professionals Unite in Urging Congress to Simplify Code," *Tax Notes*, Feb. 28, 2000, p. 1185, at 1186.

The basket system in section 904(d) seeks to preserve U.S. taxation of U.S.-source income as well as foreign-source income to the extent that a foreign country's tax imposed on such income is less than the pre-credit U.S. tax due on that income. For example, if Domestic Corporation (DC) earns $100 of business profits in Country X (which imposes a 40 percent tax rate) and $200 of business profits in the U.S. (which imposes a 35 percent tax rate), the $5 of Country X tax that exceeds the $35 U.S. tax on that income cannot be used to reduce the $70 U.S. tax on DC's U.S. business profits. *See* section 904(a) (essentially limiting the amount of DC's foreign taxes that can be credited against its U.S. tax to an amount equal to its foreign-source income multiplied by the U.S. tax rate, or $100 x 35 percent, or $35). But if all we had were section 904(a), taxpayers would be able to blend with impunity high-taxed foreign income with low-taxed foreign income to the detriment of the U.S. Treasury. For example, let's continue our example where DC has $100 of business profits arising in Country X, taxed at 40 percent, where we saw that the $5 excess foreign tax should not be creditable for U.S. tax purposes. Suppose that DC also earns $100 of interest receipts in Country Y, on which a withholding tax of 30 percent is paid, and $100 of U.S. business profits, taxed at 35 percent. Using only the section 904(a) limit, none of the $70 aggregate foreign tax would be rendered noncreditable, since the limit would equal the $200 foreign-source income multiplied by the 35 percent U.S. tax rate, or $70. Thus, the

(Footnote 23 continued on next page.)

to create the separate basket for "high withholding tax interest" in section 904(d)(1)(B) in 1986 because it accepted evidence showing that the economic burden of high gross withholding taxes on interest paid to U.S. lenders was typically shifted to the foreign borrowers.

> Congress was concerned . . . that the available evidence suggested that the economic burden of high foreign gross withholding taxes on interest falls largely, in the typical situation, on the foreign borrower rather than on the U.S. lender. To the extent that is the case, the prior rules allowing a full foreign tax credit for high foreign taxes on interest paid to U.S. lenders provided an incentive for some U.S. lenders to make foreign loans rather than domestic loans that would otherwise be equally attractive, and to make otherwise uneconomical foreign loans. The higher the applicable foreign tax on interest was, the larger the U.S. lender's foreign tax available for credit was and, thus, the greater the incentive could be. Congress was particularly concerned that foreign countries seeking to attract U.S. capital might have been encouraged by the prior law rules to increase rather than to decrease their gross withholding taxes on interest paid to U.S. persons. According to a January 1985 report in *The Wall Street Journal*, some U.S. bank lenders to Mexico responded negatively after the Mexican Government decided to exempt from a Mexican withholding tax on interest the interest payments made by a Mexican state-owned food distributor to foreign banks. The Mexican Government subsequently withdrew the exemption.[24]

In other words, the imposition of the foreign tax actually benefited these U.S. lenders receiving foreign-source interest because the lenders shifted the economic burden of the tax to the foreign borrower and yet were able, simply by grossing up the net interest received by the amount of the foreign withholding tax, to credit each dollar of foreign tax against U.S. tax. Each dollar of "gross-up," at a 35 percent tax rate, cost the lender only 35 cents, while concomitantly creating a $1 foreign tax credit, reducing U.S. tax by $1. The lender was ahead by 65 cents for each dollar of foreign gross withholding tax that the foreign jurisdiction imposed. For reasons described throughout this Part, I think that such shifting is likely true with respect to most foreign gross withholding taxes, not just high-withholding tax interest. The economic evidence accepted by Congress in 1986 when it created the separate basket for high-withholding tax interest instead supports abolishing a foreign tax credit for such withholding taxes altogether, allowing deduction only (to offset the gross up).

E. Other Shifted Taxes

Gross withholding taxes are not the only taxes that are subject to shifting, though they are the most glaring example. In most instances of U.S. businesses earning income abroad that is subject to a net income tax similar to our own (as opposed to a gross withholding tax), the incidence of the foreign tax is probably borne by the U.S. taxpayer earning the foreign income.[25] There are exceptions, however. For example, the taxpayer was able to shift the economic incidence of a foreign tax incurred on the sale of property in Revenue Ruling 57-106,[26] modified by Revenue Ruling 78-258,

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entire $70 would be creditable, which means that the excess $5 tax paid to Country X would effectively offset $5 of the residual U.S. tax due on the Country Y interest. While under international tax norms the U.S. should not have to recede its jurisdiction to collect tax on the Country Y income to the extent that Country Y's tax rates are lower than our own, exactly that would effectively happen (to the extent of $5) if there were no section 904(d). Under section 904(d), however, the section 904(a) limit is, in essence, separately computed for each "basket" of income listed there, with the Country Y interest income here placed in the "high-withholding tax interest" basket, and the Country X business profits placed in the "general limitation" basket. Since the limitation is computed separately for the general limitation basket, only $35 of the $40 paid to Country X (equal to the $100 Country X business profits x 35 percent) would be creditable for U.S. purposes. Significant blending of high-taxed foreign income with low-taxed foreign income can still occur, of course, within any one basket, in particular the general limitation basket, which places a premium on the ability to generate low-taxed foreign income of a sort that would be placed in a basket with a lot of high-taxed foreign income.

[24]Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 864-65.

[25]Because the U.S. section 11 tax on C corporations is universally regarded as shifted from the C corporation to their customers and to their suppliers of materials, services, and capital, we can assume that a corporate-level tax imposed by a foreign country on the foreign branch of a U.S. C corporation is also shifted to the C corporation's customers and suppliers of materials, services, and capital. If so, some might read my argument as requiring that U.S. C corporations be denied credits (allowing deduction only) of foreign income taxes (as opposed to gross withholding taxes) imposed on the profits of their foreign branch operations. My analysis does not, however, necessarily lead to that conclusion. This is because when a C corporation's foreign tax liability is shifted forward to customers, etc., it is in effect shifted to the very same persons who bear the U.S. tax burden. That is, awarding the foreign tax credit to the C corporation has the effect of reducing the U.S. tax that is shifted to the customers, etc., so that those people are the ultimate beneficiaries of the foreign tax credit. In this way, the C corporation serves as a practical agent for receiving and distributing foreign tax credits with respect to income taxes that are shifted forward to the C corporation's customers, etc. In *Compaq Computer* and each of the other scenarios discussed in this article, in contrast, the foreign tax is shifted to other parties in the marketplace that do not bear the economic burden of the U.S. tax that is sought to be reduced by the foreign tax credit, including asset sellers or the other party to a transaction generating the foreign-source income. The benefit of the foreign tax credit that would otherwise be allowed to taxpayers like Compaq Computer is not funneled indirectly to the person who actually shouldered the economic incidence of the tax, as would be the case with a foreign tax credit allowed to a C corporation with a foreign branch. Rather, it is retained and enjoyed by the taxpayer actually claiming the credit. My thanks go to Cliff Fleming for this perceptive insight.

[26]1957-1 C.B. 242.

described above. In Revenue Ruling 57-106, a foreign corporation purchased all of the assets of two domestic affiliates of a domestic corporation. In addition to the purchase price, the foreign corporation agreed to pay the foreign tax imposed on the U.S. seller by the foreign government relating to the sale. The ruling expressly stated that the foreign government would grant a subsidy to the foreign purchasing corporation equal to 100 percent of the foreign tax that arose on the sale. Notwithstanding the subsidy provision, the ruling concluded that the foreign tax assumed by the foreign purchasing corporation should be deemed to have been received by the U.S. seller, augmenting the sales price, and that the seller was then entitled to take a foreign tax credit for the foreign tax.

> ***Treasury and the IRS should seriously consider withdrawing Treasury regulation section 1.901-2(f)(2)(i) and Revenue Ruling 57-106.***

Revenue Ruling 78-258 modified Revenue Ruling 57-106 to eliminate any mention of the foreign subsidy program. It confirmed that, absent a foreign subsidy program that rebates the tax to the foreign buyer, the stated results remain correct: The tax paid by the foreign buyer is deemed received by the U.S. seller as part of the sales price and then a foreign tax credit is available to the seller. As noted earlier in subpart C, this approach is currently blessed in Treasury regulation section 1.901-2(f)(2)(i).

It could be argued, however, that the economic incidence of the foreign tax was not borne by the U.S. seller in Revenue Ruling 57-106, even in the absence of any subsidy program. In other words, it can be argued that Treasury regulation section 1.901-2(f)(2)(i) is wrong. The seller was able to negotiate a deal that explicitly shifted the incidence of the tax to the buyer. Since the incidence of the tax was shifted to the buyer, the tax should be completely ignored in calculating the U.S. seller's tax consequences, which means that the sales price deemed received by the seller should not include the tax, and the seller should not be entitled to take a foreign tax credit.[27]

To illustrate, assume that the sales price, without reference to the foreign tax, is $1 million, the foreign tax is $200,000, the seller's basis in the sold assets is $300,000, and the sale gain would fall entirely in the 35 percent tax bracket for U.S. tax purposes. The facts seem to indicate that the incidence of the tax was shifted to the seller. In that case, the tax should be ignored for purposes of calculating the seller's tax consequences, the seller should be deemed to have received only $1 million in sales proceeds, the seller's gain would be $700,000 ($1 million - $300,000), and the U.S. tax due would be $245,000 ($700,000 x 0.35), with no foreign tax credit.

Under the approach blessed by the Revenue Ruling and Treasury regulation, however, the seller is deemed to have received $1.2 million in sales proceeds, the seller's gain would be $900,000 ($1.2 million - $300,000), the U.S. tax due before credit would be $315,000 ($900,000 x 0.35), and the tax due after crediting the $200,000 foreign tax would be only $115,000, which is $130,000 less than described under the approach (which I think to be the correct approach) above. The seller, because of the happenstance that the foreign government taxed this transaction, was able to reduce its U.S. tax bill without incurring the economic burden of the tax because of its explicit agreement with the buyer to incur that burden in its stead.

Some might argue that my distinction turns merely on a matter of form, not substance. In connection with the facts in the ruling, for example, they would argue that it should make no difference whether the seller negotiates a sales price of $1.2 million, and remains responsible for paying the $200,000 tax itself (in which case I would argue that the seller should be entitled to a foreign tax credit), or whether the seller negotiates a sales price of $1 million, shifting the burden to the buyer under the sales contract to pay the $200,000 foreign tax otherwise imposed on the seller. Indeed, they might argue that my distinction is inconsistent with a long line of venerable cases, beginning with *Old Colony Trust Co. v. Commissioner*,[28] which conclude that when a third party pays a debt of a taxpayer, the taxpayer should be deemed to have first received the payment, which is then used by the taxpayer to pay the debt.

My response would be that *Old Colony Trust* analysis has nothing to do with the question of who incurs the economic incidence of a tax for foreign tax credit purposes. We could, if we wish, agree that *Old Colony Trust* applies in this situation. If *Old Colony Trust* applies, then the sales proceeds should be grossed up to $1.2 million, using our numbers from the hypothetical above. But that does not tell us whether the foreign tax should then be *credited* or *deducted*. It should be allowed as a credit *only* if the seller incurred the economic incidence of the tax, i.e., if the seller did not shift the economic burden of the foreign tax to the buyer. If the taxpayer did shift the economic burden of the foreign tax to the buyer, as the facts in Revenue Ruling 57-106 indicate, then the seller should be allowed only a deduction, reflecting the net proceeds actually received. The "gross-up," in other words, is not a substantive conclusion about whether the seller incurred the *economic* burden of the tax itself. When the seller is

[27]The equivalent means of achieving this result, as recounted in Part II, would be to require full inclusion of the tax as part of the sales proceeds but then allow only a deduction of the tax to reach the net sales proceeds received. As argued earlier, it seems to me to be conceptually more clear to say that the foreign tax should be simply ignored altogether. If the seller is not deemed to have incurred the incidence of the tax, there is no reason to gross up the sales price to reflect the tax paid by the buyer, which would then require allowing the seller a deduction to accurately reflect the net proceeds actually received by the seller.

[28]279 U.S. 716 (1929).

able to negotiate a price that explicitly shifts the responsibility of paying the foreign tax to the buyer, it seems to me that the seller does not earn "income" that is doubly taxed by both the U.S. and the foreign government, which is the only case in which the taxpayer should be entitled to credit the foreign tax against the U.S. tax arising on the deal. Rather, the foreign tax paid by the buyer is a tax avoided by the seller. The seller should avoid effective inclusion of the foreign tax in the sales proceeds — which is accomplished by allowing a deduction for the tax if a gross-up is required — but the seller should not be entitled to go further than that and, instead of deducting the foreign tax, offset the U.S. tax due on the deal by the foreign tax. For this reason, I think that Treasury and the IRS should seriously consider withdrawing Treasury Regulation section 1.901-2(f)(2)(i) and Revenue Ruling 57-106 altogether.

V. Conclusion

As I hope I have made clear, I am not advocating that *all* foreign taxes should be made noncreditable, but rather only deductible, as apparently former presidential candidate John McCain has advocated.[29] If the incidence of the foreign tax is borne by the U.S. taxpayer seeking to credit it, then traditional notions of capital export neutrality would support the U.S. practice of granting a foreign tax credit for those taxes. But if the incidence of the foreign tax is *not* borne by the U.S. taxpayer seeking to credit the tax, then no understanding of neutrality would require the U.S. to grant a credit (as opposed to a deduction to offset the "gross-up" that applies under current law in all cases, whether or not a foreign tax credit is allowed). Only a decision to affirmatively encourage foreign investment through a tax subsidy could lead to a decision to continue to allow a foreign tax credit for a foreign tax that is — whether because of the operation of the marketplace or the result of private contract — economically not borne by the recipient of the foreign income stream on which the tax is nominally imposed. As recounted earlier, the U.S. taxpayer subject to a 35 percent tax rate would reap a profit of 65 cents for every dollar of foreign tax so credited in that scenario. One can't help but envision U.S. taxpayers in that situation actually lobbying foreign governments to increase their tax rates at least to the level imposed by the U.S., so long as the tax is one that can be shifted, such as may be the case with virtually all foreign gross withholding taxes.

In those situations in which the economic incidence of a foreign gross withholding tax is not borne by a U.S. taxpayer, only a deduction for the tax is appropriate. Notice 98-5 and section 901(k) use proxy approaches (an economic-profit test in the former and a minimum holding period in the latter) to discourage (or, more accurately, to reduce the economically inefficient incentive to engage in) the most visible of those transactions in which taxpayers are able to shift the economic incidence of a foreign gross withholding tax to another and yet attempt to claim the foreign tax credit for that tax. But they are not the only situations in which a foreign tax credit should — at least in theory — be disallowed.

A large plug in the dam could be achieved if Congress amended the Internal Revenue Code to render foreign gross withholding taxes noncreditable (but rather only deductible) as a class.

The thoughts recounted here would support repealing the foreign tax credit (whether under section 903 or section 901) for *all* foreign gross withholding taxes on investment income if empirical evidence confirms that the economic incidence of such taxes is very often — if not always — not borne by the U.S. taxpayer receiving the income. With respect to such assets as publicly traded stock, the purchase price paid for the asset producing the income very likely is premised on the net returns (foreign tax exclusive) to be received, not the gross returns (foreign tax inclusive), over the life of the asset. This is likely the case regardless of how long the taxpayer holds the stock. In that situation, the seller of the asset bears the economic burden of the tax in the form of a reduced purchase price based on the net future return on the asset. Even with respect to privately purchased property, such as the copyright with one royalty remaining in Example 1 of Notice 98-5, the purchase price is likely depressed to a level that reflects only the net return or a price near that level. And with private lending arrangements, it is common for U.S. lenders to negotiate a return that explicitly shifts responsibility for paying any gross withholding taxes on the interest payments to the borrower.

That is, in each of these situations, the person who bears all or nearly all of the economic burden of the foreign tax is either the seller of the asset producing the income stream (such as stock or the copyright in Notice 98-5) who is unable to reap a purchase price that reflects the tax-inclusive future income stream to be produced by the asset, or the other participant in a private transaction (such as foreign debtors paying interest or the buyer in Revenue Ruling 57-106). In each case, the actual income recipient seeking to credit the tax does not likely bear the economic burden of the tax. Because many of the abusive transactions described in Notice 98-5 exploit the creditability of foreign gross withholding taxes, a large plug in the dam could be achieved if Congress amended the Internal Revenue Code to render foreign gross withholding taxes noncreditable (but rather only deductible) as a class.

Moreover, because the economic incidence of foreign taxes other than gross withholding taxes can sometimes be shifted as well, as illustrated by the facts in Revenue Ruling 57-106, Treasury should withdraw Treasury regulation section 1.901-2(f)(2)(i), which

[29] *See* R. Glenn Hubbard, "Comments on Sen. McCain's Tax Policy Toward U.S. Multinationals," *Tax Notes*, Mar. 6, 2000, p. 1433.

generally allows a foreign tax credit so long as the *legal* incidence, as opposed to the *economic* incidence, of the foreign tax is imposed on the U.S. taxpayer seeking to credit the tax. It should issue in its stead a regulation (under the authority to interpret the word "paid" in section 901) that disallows the crediting of foreign taxes in contexts that make it clear that the economic burden of the tax was not borne by the U.S. taxpayer. It should also withdraw Revenue Ruling 57-106. In these instances, it is sufficient to allow a deduction of the foreign tax only (to offset the "gross-up" that occurs under *Old Colony Trust*). International tax policy norms do not require the U.S. to reduce its tax, dollar for dollar, by a foreign tax if the U.S. taxpayer is able to shift the economic burden of the tax to another.

In short, the issue of whether the U.S. taxpayer seeking to credit a foreign tax bears the economic incidence of the foreign tax should be discussed much more openly and forthrightly in considering which foreign taxes ought to be rendered merely deductible rather than creditable, regardless of the "innocence" or "culpability" of the taxpayer who is lucky enough to shift the economic burden of a foreign tax to others in the marketplace.